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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1654

CONSUMER FEDERATION OF AMERICA,
ENERGY POLICY TASK FORCE,

Petitioner,

v.

FEDERAL REGULATORY ENERGY
COMMISSION.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Consumer Federation of America's Energy Policy Task Force ("EPTF") */ petitions this Court to issue a writ

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*/ EPTF is a broad based coalition of over 50 major national consumer organizations, labor unions, farm groups, urban-based organizations, public power associations, and rural electric cooperatives, concerned with national energy matters.

of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. A., infra, pp. 1a-10a) is reported at 566 F.2d 536. Order 539-B of the Federal Power Commission is reproduced in Appendix B, infra, pp. 11a-29a.

JURISDICTION

The judgment of the court of appeals was entered on January 20, 1978. An application for an extension of time within which to file a petition for a writ of certiorari, to and including May 20, 1978, was granted on April 23, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Whether the Federal Energy Regulatory Commission is precluded by the "production and gathering" exemption contained in Section 1(b) of the Natural Gas Act from enforcing, in accordance with an appropriate standard, the delivery obligations under certificates of public convenience and necessity issued to producers of natural gas pursuant to Section 7 of the Act.

2. Whether the "prudent operator standard" constitutes a proper measure for enforcing delivery obligations under certificates of public convenience and necessity.

STATUTES INVOLVED

Sections 1(b), 7(b), 7(c) and 7(e) of the Natural Gas Act, 15 U.S.C. § 717(b), § 717f(b), § 717f(c), and § 717f(e), are, in relevant part, reproduced in Appendix C, infra, pp. 30a-32a.

STATEMENT

The opinion of the Fifth Circuit in this litigation is the subject of two petitions for certiorari -- the instant one and a petition being filed by the Federal Energy Regulatory Commission in Federal Energy Regulatory Commission v. Shell Oil Company, et al. The petitions relate to Order 539-B (App. B, infra, p. 11a), issued by the Commission's predecessor, the Federal Power Commission ("Commission"), as a statement of policy and standards governing the enforcement of natural gas delivery obligations certificated by the Commission under Section 7 of the Natural Gas Act, 15 U.S.C. § 717f.

The issuance of Order 539-B and the judicial review of that Order sought by both industry and petitioner Energy Policy Task Force, arise in a context unprecedented in the history of natural gas regulation. From the passage of the Natural Gas Act in 1938 until only a few years ago, the primary focus of Commission regulation had been on the price consumers would pay for gas transported in interstate commerce. The adequacy of supply was never really an issue; in fact, the market for natural

gas was a buyer's market. */ Since the late 1960s, however, the primary problem has been a growing shortage of natural gas, **/ and the major challenge for the Commission now lies in assuring the fulfillment of preexisting delivery obligations and the devising of measures to allocate a dwindling supply among competing uses. A corollary to the growing shortage is the fact that, for the first time, there is a substantial incentive for producers not to deliver all the gas available from their fields, but rather to sell their gas in the unregulated intrastate market or to conserve their supplies in hopes that

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*/ Federal Power Commission, National Gas Survey, Vol. I, p. 114 (1975).

**/ See, e.g., Mobil Oil Corp. v. Federal Power Commission, 417 U.S. 283, 331 (1974); Federal Power Commission v. Louisiana Power & Light Co., 406 U.S. 621, 626 & n.2 (1972); Pacific Gas & Electric Co. v. Federal Power Commission, 506 F.2d 33, 35 (D.C. Cir. 1974); Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, Federal Regulation and Regulatory Reform, H.R. Doc. No. 95-134, 94th Cong., 2d Sess. 385-388 (1976). See also FPC Staff Report No. 2, National Gas Supply and Demand 1971-1990 (1972): "The emergence of a natural gas shortage during the past two years marks an historic turning point -- the end of
(footnote continued)

deregulation, or Commission action on rates, will raise the price they can charge for interstate sales. */

In order to assist in dealing with the problems of dwindling supplies, and amidst increasing allegations of intentional withholdings of interstate deliveries for diversion to the intrastate market, the Commission enunciated its policy with respect to the enforcement of certificated obligations by issuing Order 539 on October 14, 1975.

(footnote continued)
natural gas industry growth uninhibited by supply considerations." Id. at xi.

*/ Reflective of the growing shortage and the general incentive created by the disparity between interstate and intrastate rates are computations contained in a June 1977 FPC Bureau of Natural Gas Staff Report, entitled "Report of Monthly Curtailments Based on FPC Form No. 17," which shows that cumulative firm curtailment in the interstate market has grown from 17,535,000 Mcf in 1970 to 3,181,903,600 Mcf in 1976. Id., Schedule II, Sheets 2-4. Similarly, the interstate market's share of new reserve additions, reported by the American Gas Association, has fallen precipitously, while the intrastate market's share has increased dramatically. Thus, in 1966, 68% of the reserve additions were dedicated to the interstate market; by 1975, that
(footnote continued)

40 Fed. Reg. 49571 (October 23, 1975). */ There, the Commission stated that it had been and continued to be the Commission's policy:

> to enforce all deliverability and supply obligations of jurisdictional natural gas producers and jurisdictional natural gas pipelines, as they may be occasioned by applicable regulations of the Commission and the statutory standards of the Natural Gas Act, which govern -- and, therefore, which are incorporated within -- the certificates for all certificated arrangements authorized pursuant to the Act. Id. at 49571, col. 2.

In so doing, the Commission made it clear that its certificates imposed obligations on natural gas companies

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(footnote continued)
figure had fallen to 13%, with the remaining 87% dedicated to the intrastate market. FPC Opinion No. 770-A, November 5, 1976, at 116.

*/ For Congressional inquiries regarding fulfillment of delivery obligations, see Order 539, fn. 1. Id.

extending beyond the terms of individual contracts between producer and pipeline. Id., at 49572, col. 2.

To aid it in carrying out this policy, the Commission in Order 539 added a new section, § 2.83, to the General Policy and Interpretations in Title 18 of the Code of Federal Regulations. In subsection (a) of § 2.83, the Commission stated:

> [n]atural gas companies . . . shall comply with all deliverability or production of natural gas requirements to meet, inter alia, certificated operations, services, developments, quantities, volumes, or sales. Id., at 49573, col. 3 (emphasis added).

Subsection (d) of § 2.83 then set forth specific terms to be included in all future certificates, imposing on the certificate holder the obligation to report the results of any reserve determination or redetermination, and clearly stating that the producer had a "certificated minimum delivery obligation" to be determined by reference to the contract provision, as modified by the certificate, and to remain in force unless a change were authorized by the Commission, based upon the certificate holder's documentation to the Commission of the reasons for the change. Id., at 49573, col. 1.

The issuance of Order 539 brought forth a storm of protest from the producers, in the form of applications for rehearing and reconsideration. As a result, the Commission issued Order 539-A on March 26, 1976. 41 Fed. Reg. 14531 (April 6, 1976). While defending the position enunciated in Order 539, the Commission began to retreat significantly from its previous position on delivery obligations, shifting its focus from the Natural Gas Act and the certificates issued thereunder, to the private contract entered into between the producer and the pipeline. Thus, the Commission stated that in its earlier Order 539, it:

> intended to inform the parties to gas sales contracts that once deliveries under such contracts, as certificated by the Commission, commence in interstate commerce, such deliveries continue without unjustifiable unilateral interruption in accordance with the applicable provisions of the contract. Id., at 14532, col. 1. */ (Emphasis added.)

The Commission also gave notice of a rulemaking proceeding and hearing, designed to gather information con-

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*/ See also similar characterization at 14531, col. 3.

cerning the obligation of "parties accepting a certificate of public convenience and necessity from this Commission," and of its intention to amend § 2.83 accordingly. Id., at 14533, col. 1.

Both the industry and EPTF participated at the proceeding, through written comments and testimony. The producers argued, inter alia, that efforts by the Commission to enforce delivery obligations would run afoul of the "production and gathering" exemption contained in Section 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b), and that the underlying sales contracts placed no firm delivery obligations on producers. EPTF urged the Commission to return to the policy initially enunciated in Order 539 -- that certificate obligations take precedence over contract obligations -- and to measure the certificate obligation either by the level of service actually provided in the past or as defined by representations made at the time of application for a certificate.

Following the oral argument, the Commission, on July 30, 1976, issued Order 539-B to "clarify" its prior orders. (App. B, infra, pp. 11a, 11b.) Despite the fact that the notice of rulemaking provided by Order 539-A had indicated a purpose simply to "amend" § 2.83 of the Commission's General Policy and Interpretations, Order 539-B repealed that section entirely, including the reporting and approval requirements found in § 2.83(d). (App.

B, p. 22a.) In its place, the Commission enacted a new section -- § 157.41 -- of its regulations. (App. B., p. 23a.)

With this abrupt change, the Commission abandoned entirely the approach set forth in § 2.83 which focused upon the Commission's certification itself; instead the Commission essentially endorsed the contract between the producer and pipeline as establishing the contours of certificated obligations, while modifying those privately negotiated terms by the incorporation of a further contract concept -- "prudent operation." In describing the resultant nature of certificated obligations, the Commission stated:

> Once deliveries have commenced under the certificate, as conditioned, the responsibility for the development and maintenance of gas reserves underlying the committed acreage rests with the producer, and the applicable standard by which to judge whether a producer is properly proceeding with these obligations will be the above referenced "prudent operator standard." (App. B., p. 17a.)

The Order further stated that the prudent operator standard was adopted not because it reflected producer service obligations stemming from the certificates but essentially because it was a standard with which producers were "acquainted," through their own private lease arrangements and the regulation of certain state and federal agencies. (App. B, p. 17a.)

On the date Order 539-B was issued, Shell Oil Company petitioned for review of the Commission's orders in the Fifth Circuit, and other producers promptly followed suit. EPTF filed a timely motion to intervene in the Fifth Circuit and also applied to the Commission for reconsideration and modification of Order 539-B. After rehearing was denied, EPTF filed a petition for review in the Court of Appeals for the District of Columbia Circuit, which was subsequently transferred to the Fifth Circuit.

The matter was fully briefed by the producers, EPTF, and the Commission before the Fifth Circuit and oral argument was held on July 6, 1977. On January 20, 1978, the Fifth Circuit issued its opinion, declaring Order 539-B's "prudent operator" standard invalid, as contravening the jurisdictional exemption for production and gathering activities contained in Section 1(b) of the Act. Although recognizing that, under prior holdings of this Court, the Commission clearly has jurisdiction to "enforce 'service obligations' contained in certificates that it issues to producers [in order to prevent] producers from ceasing deliveries from fields . . . capable of continuing production" (App. A., p. 7a),

the court concluded:

> Order 539-B clearly is intended to open the door to [Commission] involvement into forbidden production activities. . . . To hold that the power to issue Order No. 539-B is within the jurisdiction of the [Commission] would all but eliminate the "production and gathering" exclusion and would allow the [Commission] to encroach on areas reserved to the states. (App. A., p. 10a.)

In so holding, the court of appeals did not reach the challenges to Order 539-B posed by EPTF, nor did it explain how the Commission might effectively exercise its admitted certificate enforcement powers.

REASONS FOR GRANTING WRIT

This petition for certiorari and that filed by the Federal Energy Regulatory Commission pose important issues relating to the interpretation of the Natural Gas Act involving, in particular, the nature of the certificated obligations of natural gas companies and the jurisdiction of the Commission, in light of the "production and gathering" exemption in Section 1(b) of the Act, to enforce those obligations. Seen more broadly in the context of the current energy shortage, this case presents a crucial question of national

importance, with far-reaching economic implications.

Consumers -- individual users and industrial and business firms -- have a critical and justified reliance upon the continued flow of natural gas. As a 1975 Commission report pointed out, "the events of the past year have illustrated in dramatic and unmistakable terms the alarming degree to which this Nation's economic and social welfare are dependent upon assured and adequate energy supplies." */ Over "84 percent of the U.S. population lives in communities served with gas." **/ Industry, too, relies heavily on natural gas -- due to major investments of capital, pollution-control considerations and, in some cases, the lack of a suitable substitute fuel. ***/ In short, a nation-wide network of interrelated obligations, investments and economic and social well-being has developed upon the continued supplies of natural gas committed to the interstate market pursuant to the certificates of convenience and necessity issued by the Commission. While this network is not

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*/ Federal Power Commission, National Gas Survey, Vol. I, p. 6 (1975).

**/ Homeowners' investment in gas appliances alone exceeds $20 billion. Id. at 50.

***/ Id. Industrial uses account for 68.9 percent of total natural gas
(footnote continued)

immutable, and must adapt to the realities of diminishing supplies, that reliance interest must be protected to the extent it is based on already dedicated reserves. */

Regardless of whether available and presently certificated volumes of natural gas are being intentionally withheld from the interstate market, in hopes of deregulation or in response to the blandishments of the intrastate market, the existence of a shortage poses unique challenges to the regulatory scheme envisioned by the Natural Gas Act, and especially to the Commission if it is to fulfill its obligation under the Act to protect the consuming public from the self-interested actions of natural gas companies. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944).

(footnote continued)
consumption in 1972. Id. at 38.

*/ It is important to note that the question of enforcement of existing delivery obligations will not be eliminated if the natural gas deregulation proposals currently being considered by Congress become a reality. The proposal most recently put before the House and Senate natural gas conferees provides for phased deregulation of new gas preceded by guaranteed price increases tied to inflation, with (footnote continued)

The Commission seemed to recognize the importance of this challenge when it enunciated its enforcement policy in Order 539, with its reporting provisions and firm requirement of Commission approval for deliveries failing to fulfill certificated obligations. With the subsequent issuing of Orders 539-A and 539-B, however, the Commission retreated from its original approach and adopted a standard that is based essentially upon a contractual concept unrelated to the certification process, and that is so vague as to be unenforceable. As a result, the Commission has managed since the onset of the natural gas shortage to mount only one meaningful enforcement effort, */ and remains

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(footnote continued)
additional annual escalators. Thus, subject to certain exemptions, already dedicated gas reserves would remain under regulatory price controls, at least until 1985 and, accordingly, such dedicated supplies would continue as an important source of lower priced gas for current consumers. House and Senate Natural Gas Conference, "Compromise Natural Gas Pricing Proposal" (May 3, 1978).

*/ See Gulf Oil Corporation v. Federal Power Commission, 563 F.2d 588 (3d Cir. 1977), cert. denied, 46 U.S.L.W. 3520 (February 21, 1978). The potential results of concerted enforcement efforts (footnote continued)

without an effective program for ensuring fulfillment of the delivery obligations it certificates. Essential to such a program are firm, clearly articulated standards, grounded in the concept of service under the Act, with adequate procedures for assuring Commission ability to focus limited resources on potentially non-complying activity. These are the features missing from Order 539-B and their absence, along with the accompanying jurisdictional question, warrant the grant of certiorari here.

1. Central to the Natural Gas Act's charge to the Commission "to protect consumers against exploitation at the

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(footnote continued)
are well demonstrated by events following the Gulf enforcement action. During the four-month period November 1976 through February 1977, Gulf's deliveries fell short of its certificated obligations by over 16,000,000 Mcf, as had been true for several prior years. Yet, following vigorous enforcement by the Commission, Gulf delivered 6,250,000 Mcf in excess of its certificate obligations during the 12 months from April 1977 through March 1978. Gulf Oil Corporation, Supplemental Statement Reflecting Refund and Interest, Docket No. CI 64-26, filed May 3, 1978 with the Federal Energy Regulatory Commission.

hands of natural gas companies," */ is the power to grant, deny and enforce certificates of public convenience and necessity, 15 U.S.C. § 717f. This Court has termed the certificate the "heart" of the Act, because it is a prerequisite to the transportation of natural gas in interstate commerce and the sale of natural gas for resale in the interstate market. Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378, 388 (1957); 15 U.S.C. §§ 717, 717f.

The Commission is authorized to issue a certificate only if it finds that the applicant is "able and willing properly to do the acts and to perform the service proposed . . . ," 15 U.S.C. § 717f(e). As part of its application for a certificate, the producer submits its pipeline sales contract, along with various data bearing upon its anticipated level of service, 18 C.F.R. §§ 157.23-157.25. The pipeline contracting for the gas submits similar information, as well as detailed data on estimates of reserves and deliverability, 18 C.F.R. § 157.14. Following the issuance of a certificate by the Commission, the Act clearly states that there shall be no reduction in -- or abandonment of -- service without the approval of the Commission. 15 U.S.C. § 717f(b).

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*/ Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 610
(footnote continued)

The primacy of the certificate over private contractual rights, and the certificate's focus on service, have been repeatedly recognized by this Court. Sunray Mid-Continent Oil Co. v. Federal Power Commission, 364 U.S. 137, 152 (1960); Sun Oil Co. v. Federal Power Commission, 364 U.S. 170 (1960); Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378 (1959). See also Mitchell Energy Corp. v. Federal Power Commission, 533 F.2d 258 (5th Cir. 1976); Michigan Consolidated Gas Co. v. Federal Power Commission, 283 F.2d 204, 214 (D.C. Cir. 1960), cert. denied, 364 U.S. 913 (1960). */ Yet, despite this case law

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(footnote continued)
(1944). See also Federal Power Commission v. Texaco, Inc., 417 U.S. 380, 397-98 (1974); Mobil Oil Corp. v. Federal Power Commission, 417 U.S. 283, 321 (1974).

*/ In one of the earlier decisions on this subject, the Third Circuit explicitly rejected a company's arguments that abandonment was automatically justified by the operation of an escape clause in the certificated contract, stating:

> " . . . and most important, service to the public was the foundation of the contract operation. That service was given. The public has relied on it through the years and

(footnote continued)

and numerous references to the concept of continuing service as the justification for the terms of Order 539-B (App. B., pp. 13a, 15a, 16a), the standard of "prudent operation" actually proposed in that Order is wholly devoid of any concept of service. Indeed, in describing the operation of the "prudent operator" standard itself, the Commission makes no further mention of "service." (App. B., pp. 16a-18a.)

Equally as disturbing as this failing is the course of action followed by the Commission in arriving at the "prudent operator" standard. Having dismissed the producer contention that their contracts with the pipelines contain no firm obligations but permit them virtually unfettered control over the deliverability of natural gas (App. B., pp. 13a, 13b), the Commission did not proceed to a more careful examination of typical contracts, in order to extract some common denominator. */

(footnote continued)

> is entitled to its fair continuance. To abandon it there must be Commission approval." (Emphasis added.)

J.M. Huber Corp. v. Federal Power Commission, 236 F.2d 550, 558 (3rd Cir. 1956), cert. denied, 352 U.S. 971 (1957).

*/ To the contrary, at least on the face of the Orders, the Commission by and

(footnote continued)

Nor did it examine the certification process to see what guidance the various undertakings or submissions there might provide in defining "certificated obligations." Instead, the Commission reached outside the certification process, drawing the concept of "prudent operation" from private lease agreements and state law. Having identified the circumstances in which this concept had been used, the Commission simply concluded that the standard was appropriate because "all producers are acquainted" with it (App. B., p. 17a). In so doing, the Commission seriously strayed from its proper role of construing existing certificate obligations, both explicit and implied. */ See Sunray Mid-Continent Oil Co. v. Federal Power Commission, supra; Sun Oil Co. v. Federal Power Commission, supra.

(footnote continued)
large contented itself with abiding by the producers' characterization of their contractual obligations. See, e.g., the discussion in Order 539-B regarding "minimum daily delivery obligations," where the Commission simply stated, with reference to the producer response, "we must conclude that the clause is not one that has a generally accepted meaning among pipelines and producers." (App. B., p. 12a).

*/ Moreover, the standard seems particularly inappropriate, since it is (footnote continued)

2. Given the present severe gas shortage and the conflicting demands such a shortage places on scarce supplies, the need for precise, definite standards and an assured enforcement mechanism are critical. Otherwise, consumers and natural gas companies alike will be at a loss to understand their rights and obligations. Unfortunately, the "prudent operator" standard fails to meet this test and thus runs afoul of the appropriate standard of "reasonableness." Placid Oil Co. v. Federal Power Commission, 483 F.2d 880, 888-89 (5th Cir. 1973), aff'd sub nom, Mobil Oil Corp. v. Federal Power Commission, 417 U.S. 283 (1974); Shell Oil Company v. Federal Power Commission, 520 F.2d 1061, 1070-71 (5th Cir. 1975), cert. denied, 426 U.S. 941 (1976). See also Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). In the process, it similarly fails to provide an appropriate mechanism to assist the Commission in its task of protecting consumers' interests. Federal Power Commission v. Hope Natural Gas Co., supra.

(footnote continued)
derived primarily from lessor-lessee contract law where it was designed to protect the lessor's private pecuniary interests.

The fluid nature of this "reasonableness" standard is apparent on its face, and is underscored by the few illustrative factors identified by the Commission in Order 539-B, e.g., performance requirements in the lease arrangement, valid state law, and prudent practice (App. B, p. 17a). And, if anything, the origins of the standard will only tend to confuse the matter further. The Commission admitted as much in the court of appeals where it said that "due to public interest considerations," it could not enforce "exactly the prudent operator standard used by a lessor or purchaser . . ." Brief of Respondent Federal Power Commission, at p. 25. In summary, we submit, a more workable standard, comprehensible to the regulated and the beneficiaries of regulation alike, is mandated by the Act. */

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*/ This seems particularly so, when an alternative approach, more consistent with the Act's requirements, can be readily developed. Such a system would, as indicated by Sunray and later decisions of this Court, focus on service provided, as amplified by, inter alia, the contract underlying the certificate and the submissions made at the time of application. It would be accompanied by an adequate reporting system, with a mechanism to assure Commission approval of declining deliveries. Recognition both of the inevitable decline in production, and the short
(footnote continued)

3. The producers broadly assert that Section 1(b) of the Natural Gas Act (App. C., p. 30a) bars Commission enforcement of certificated delivery obligations. See, e.g., Order 539-B, App. B., 20a; Order 539-A, supra, 41 Fed. Reg. at 14581, col. 3. */ While the Fifth Circuit declined to accept this claim (App. A., p. 7a), its opinion nevertheless casts a pall over the authority of the Commission to implement an enforcement policy. This fact is reason enough for the granting of certiorari in this case. While we do not address the issue of the Commission's jurisdiction to enforce delivery obligations under a "prudent operator" standard, we do submit that past decisions of this Court should leave little doubt as to the authority of the Commission to require compliance with appropriate standards governing those

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(footnote continued)
term swings, would of course be a necessary part of the system which, incidentally, would appear to be quite similar to that envisioned by § 2.83 of Order 539 -- the order initially issued by the Commission.

*/ Indeed, as indicated above, many producers also argue that they have retained total delivery discretion under their contracts, thus on the basis of contract terms at least, leaving the Commission with no ascertainable obligations to enforce. See p. 19, supra.

obligations. */ United Gas Improvement Co. v. Continental Oil Co., 381 U.S. 392 (1965); Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954). See also Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

In considering this question, it is critical to note the enormous investments made by natural gas pipelines to transport gas in interstate commerce. These investments are made in light of delivery contracts with producers and pursuant to the certificates issued by the Commission, based upon the detailed information submitted by pipelines, and behind them, by the producers. The pipelines in turn contract with distributors, setting in motion an elaborate system of investments, and reliance upon natural gas deliveries, terminating in end use by the individual consumer or industrial establishment. To deny the Commission the authority to enforce producers' certificated delivery obligations would be to pull the underpinnings from this extensive network, and in the process, to seriously

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*/ At the same time, we note that the standard proposed by EPTF less directly implicates production and gathering activities than does the "prudent operator" standard, although some impact upon production and gathering is perhaps inevitable in the enforcement of producers' delivery obligations.

inhibit the underlying purpose of the Natural Gas Act. Similarly, to delay a firm resolution of this matter, knowing the producers' position on the jurisdictional question and in light of the negative impact of continued uncertainty upon the Commission's regulatory activity, would seem inappropriate.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

SHELL OIL COMPANY et al., Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION, Respondent.

No. 76-3066, Et Al.

United States Court of Appeals,
Fifth Circuit.

Jan. 20, 1978.

On petition of natural gas producers for review of a Federal Energy Regulatory Commission order, the Court of Appeals, Tjoflat, Circuit Judge, held that the specific statutory exclusion of "the production and gathering of natural gas" from FERC jurisdiction prohibited FERC from issuing Order No. 539-B, which established a regulation requiring a producer to act as a "prudent operator" in developing and maintaining deliverability from natural gas reserves, and FERC could not use the power to issue certificates to extend its jurisdiction into the excluded area.

Vacated and remanded.

1. War and National Emergency ⇐305

The specific statutory exclusion of "the production and gathering of natural gas" from the jurisdiction of the Federal Energy Regulatory Commission prohibited FERC from issuing Order No. 539-B, which established a regulation requiring a producer to act as a "prudent operator" in developing and maintaining deliverability from natural gas reserves, and

1. Order No. 539-B, — F.P.C. —, 41 Fed.Reg. 32,883 (1976), establishes 18 C.F.R. § 157.41 (1977), which provides:

FERC could not use the power to issue certificates to extend its jurisdiction into the excluded area. Natural Gas Act, §§ 1(b), 7(e), 15 U.S.C.A. §§ 717(b), 717f(e).

2. War and National Emergency ⇐303

Natural gas producers are subject to the jurisdiction of the Federal Energy Regulatory Commission when they engage in activities that can be classified as sales or transportation rather than as production or gathering. Natural Gas Act, §§ 1(b), 7(e), 15 U.S.C.A. §§ 717(b), 717f(e).

3. War and National Emergency ⇐305

The Federal Energy Regulatory Commission can enforce "service obligations" contained in the certificates that it issues to natural gas producers, preventing producers from ceasing deliveries from fields admittedly capable of continuing production. Natural Gas Act, §§ 1(b), 7(e), 15 U.S.C.A. §§ 717(b), 717f(e).

Petitions for Review of Orders of the Federal Power Commission.

Before CLARK, RONEY and TJOFLAT, Circuit Judges:

TJOFLAT, Circuit Judge:

Shell Oil Company and other natural gas producers bring this petition to review the Federal Energy Regulatory Commission's (FERC) Order No. 539–B, —— F.P.C. ——, 41 Fed.Reg. 32,883 (1976), which established a regulation requiring a producer to act as a "prudent operator" in developing and maintaining deliverability from natural gas reserves.[1] The primary issue before us is whether

> On and after July [30], 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in inter-

this Order exceeds the Commission's jurisdiction to regulate the transportation and sale of natural gas in interstate commerce.

The FERC claims that the "prudent operator" obligation is an implied condi-

> state commerce shall be conditioned as follows:
>
> All persons making jurisdictional sales pursuant to the authority granted by this certificate are hereby given notice that the contractual obligations between the buyer and the seller are incorporated into the certificate obligations, and that the certificate is further conditioned to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated hereunder.

Order No. 539–B is the third in a series of FERC orders, dealing with the development and maintenance of natural gas reserves. The first, Order No. 539, —— F.P.C. ——, 40 Fed. Reg. 49,571 (1975), was issued on October 14, 1975, without any notice, comment, or hearing as required for rule-making by the Administrative Procedure Act, 5 U.S.C. § 553 (1970). This Order stated the FERC's intention to enforce "delivery and supply obligations" purportedly contained in producer contracts and producer and pipeline certificates. The FERC's General Policy and Interpretations was amended by this Order by adding a new section, 18 C.F.R. § 2.83 (1975), delineating the FERC's policy on the enforcement of deliverability of natural gas services. On November 28, 1975, the Commission granted reconsideration of Order No. 539 on the application of a number of producers who asserted, among other grounds, that Order No. 539 misinterpreted both the producer-pipeline contractual arrangements and the existing certificate obligations. Issue was also taken with the institution of § 2.83 without following rule-making procedures. Administrative Procedure Act, 5 U.S.C. § 553 (1970). On March 26, 1976, the FERC issued a second order, Order No. 539–A, —— F.P.C. ——, 41 Fed.Reg. 14,531 (1976), to clarify its previous Order and properly to give notice of the intention of the Commission to promulgate § 2.83 pursuant to a rule-making procedure. Finally, the FERC issued Order No. 539–B, withdrawing § 2.83 and instituting § 157.41, on July 30, 1976.

tion of the certificates of public convenience and necessity that are required under the Natural Gas Act before companies may transport or sell natural gas in interstate commerce. The Commission relies upon the concept expressed as

> The impetus behind the FERC's actions was the charge made before various subcommittees of Congress that natural gas producers were avoiding the delivery obligations in their contracts of sale in order to realize greater profits. It was claimed that the producers were diverting natural gas from interstate to intrastate sales or withholding it in hope of future deregulation of the industry. No support for this charge appears in the record before us and the FERC stated in oral argument that its investigation has uncovered no evidence that the natural gas producers have been withholding supplies. We have held that when an FERC order originated in a policy decision of the agency and not as the outgrowth of factual determinations, the standard of review is whether the agency's action was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A) (1967). Under that standard we determine "whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Superior Oil Co. v. FERC*, 563 F.2d 191, at 201 (5th Cir. 1977).

Section 7(e) of the Natural Gas Act requires the FERC to make findings that a proposed retroactive condition, such as the one imposed by Order No. 539–B, is reasonable and is required by the public convenience and necessity. *Pure Oil Co. v. FPC*, 292 F.2d 350, 352–53 (7th Cir. 1961); *see Atlantic Refining Co. v. Public Service Comm'n*, 360 U.S. 378, 394, 79 S.Ct. 1246, 1256, 3 L.Ed.2d 1312 (1959) (Harlan, J., concurring) and *Texaco, Inc. v. FPC*, 290 F.2d 149, 157 (5th Cir. 1961). In light of the FERC's admission that the natural gas producers were not withholding natural gas from interstate commerce, it is questionable whether Order No. 539–B can survive the limited review explicated in *Superior Oil Co.* We need not reach this question, however, since it will be shown *infra* that Order No. 539–B is beyond the FERC's jurisdiction.

"service" in the Natural Gas Act[2] to establish its authority to hold certificate recipients to the "prudent operator" standard. No separate statutory or regulatory grant of jurisdiction has been cited by the FERC.

[1] The producers, however, argue that the FERC is prohibited from issuing Order No. 539–B by the specific exclusion of "the production and gathering of natural gas" from the Commission's jurisdiction and that the FERC cannot use the power to issue certificates to extend its jurisdiction into the excluded area.[3] We agree with the producers and vacate the FERC's Order.

[2] The jurisdiction of the FERC to regulate the natural gas industry is delineated by § 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b) (1970):

> The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural

2. Natural gas companies perform a service to the public, and the Commission's authority extends to ensuring that the service is properly performed even if it is not specifically manifested in a contractual relationship. *Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137, 80 S.Ct. 1392, 4 L.Ed.2d 1623 (1960). This service is derived from the section of the Natural Gas Act empowering the FERC to issue certificates:

> . . . [a] certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions

gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

The producers are subject to the jurisdiction of the FERC when they engage in activities that can be classified as sales or transportation rather than as production or gathering. *Phillips Petroleum Co. v. State of Wisconsin*, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1954). Through the years, the "production or gathering of natural gas" exemption has been judicially narrowed. The progression can be seen by comparing *FPC v. Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 69 S.Ct. 1251, 93 L.Ed. 1499 (1949) with *United Gas Improvement Co. v. Continental Oil Co. (Rayne Field)*, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 (1965). The *Panhandle* case held that gas leases relate to the production or gathering of natural gas and are thus outside the jurisdiction of the FERC. The Supreme Court narrowly construed *Panhandle* in *Rayne Field* when it held that leases that are in essence sales of the gas reserves are within the FERC's jurisdiction. In *Rayne Field* the producers recast a conventional wellhead pur-

of this chapter and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require. 15 U.S.C. § 717f(e) (1970).

3. Natural Gas Act § 1(b), 15 U.S.C. § 717(b) (1977). This was the position taken by Commissioner Watts in his dissent from Order No. 539–B.

chase of natural gas as a purchase of the leasehold interests in the natural gas field. The Supreme Court described this sale of leasehold interests as "very close in economic effect to [traditional] sales of natural gas," *id.*, 85 S.Ct. at 1520, and stated that:

> *The "production or gathering" exemption relates to the physical activities, processes and facilities of production or gathering,* but not to sales of the kind affirmatively subjected to Commission jurisdiction. This accommodation of the two relevant clauses of § 1(b) gives content to the national objectives of the Natural Gas Act as expanded in Phillips, and to the Commission's jurisdiction to accomplish them, while in no way interfering with state regulatory power over the physical processes of production or gathering in furtherance of conservation or other legitimate state concerns. *Id.* 381 U.S. at 403, 85 S.Ct. at 1523. (Emphasis added.)

[3] The FERC can enforce "service obligations" contained in the certificates that it issues to producers, preventing producers from ceasing deliveries from fields admittedly capable of continuing production. This doctrine was developed in *Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137, 80 S.Ct. 1392, 4 L.Ed.2d 1623 (1960) and *Sun Oil Co. v. FPC*, 364 U.S. 170, 80 S.Ct. 1388, 4 L.Ed.2d 1639 (1960), based on the power to issue certificates, see note 2 *supra*, and prevents producers from beginning delivery to another party after the initial contracts expire. Another line of cases permits the FERC to regulate the "abandonment of service." *Mitchell Energy Corp. v. FPC*, 533 F.2d 258 (5th Cir. 1976); *Panhandle Eastern Pipe Line Co. v. Michigan Consolidated Gas Co.*, 177 F.2d 942 (6th Cir. 1949).

No case has been found, however, that extends FERC jurisdiction directly into the physical activities, processes, and facilities of production and development. The cases recognizing the broad scope of the FERC's authority have nonetheless also recognized the "production or gathering" exclusion. In *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 65 S.Ct. 829, 89 L.Ed. 1206 (1945), after holding that the FERC could include production properties in the rate base of an interstate pipeline company, the Supreme Court stated:

> that does not mean that the part of § 1(b) which provides that the Act shall not apply "to the production or gathering of natural gas" is given no meaning. Certainly that provision precludes the Commission from any control over the activity of producing or gathering natural gas. For example, it makes plain that the Commission has no control over the drilling and spacing of wells and the like. *Id.* at 602–03, 65 S.Ct. at 839.

In *Continental Casualty Co. v. Associated Pipe & Supply Co.*, 447 F.2d 1041, 1052 (5th Cir. 1971), we echoed Mr. Justice Black's definition of "the production or gathering of natural gas:"

> "Production" of gas [means] the act of bringing gas from the earth, and "gathering" [means] the act of collecting gas after it has been brought forth. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 518, 69 S.Ct. at 1262 (Black, J., dissenting).

See also Northern Natural Gas Co. v. State Corporation Comm'n, 372 U.S. 84, 90, 83 S.Ct. 646, 650, 9 L.Ed.2d 601 (1963) (" 'production' and 'gathering' are terms narrowly confined to the physical acts of drawing the gas from the earth and preparing it for the first stages of distribution.")

Order No. 539–B clearly is intended to open the door to FERC involvement into forbidden production activities: [4]

> This [prudent operator] standard encompasses the obligations to develop the properties consistent with the performance requirements of lease agreements with mineral owners and/or assignors; all valid rules and regulations of any Federal, state or local government having jurisdiction; and the *standard of what a reasonably prudent producer would do with respect to the*

4. During oral argument, the FERC's counsel first stated that the FPC could require producers to drill new wells pursuant to Order No. 539–B; counsel later withdrew from this position and stated that the Commission could not do so because such a requirement would be beyond its power. The Commission staff, however, has not adopted a restrictive view of the authority granted to the FERC under Order 539–B. In its initial brief to the FERC in Docket No. RI75–112 (Dec. 6, 1976), the Staff stated:

> Immediate development of these known proved reserves will serve the public interest by increasing the supply of natural gas available to the interstate market. In the event that such development is not undertaken voluntarily by the producers, *staff recommends that the Commission use its authority pursuant to Order 539–B to insure full and timely development of these dedicated proved reserves.*
>
> An answer to the question of whether *production from "behind the pipe" reserves should be accelerated by drilling new wells* involves a policy determination based on a careful consideration of a number of factors . . . *Id.* at 213. (Emphasis added.)

5. The Supreme Court has discussed extensively the legislative history of the Natural Gas Act in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 (1954) and *FPC v. Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 69 S.Ct. 1251, 93 L.Ed. 1499 (1949). *See also Panhandle Eastern Pipe Line Co. v. Public Service Comm'n of Indiana*, 332 U.S. 507, 514–21, 68 S.Ct. 190, 193–97, 92 L.Ed. 128 (1947); *Interstate Natural Gas Co. v. FPC*, 331 U.S. 682, 689–90, 67 S.Ct. 1482,

drilling completion, workover, recompletion or abandonment of wells. —— F.P.C. at ——, 41 Fed.Reg. at 32,884. (Emphasis added.) (Footnote omitted.)

To hold that the power to issue Order No. 539–B is within the jurisdiction of the FERC would all but eliminate the "production or gathering" exclusion and would allow the FERC to encroach on areas reserved to the states.[5] We cannot so extend the authority of the Commission.[6]

VACATED AND REMANDED.

1486–87, 91 L.Ed. 1742 (1947); *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 601–03, 65 S.Ct. 829, 838–39, 89 L.Ed. 1206 (1945); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 609–13, 64 S.Ct. 281, 291–92, 88 L.Ed. 333 (1944); *Illinois Natural Gas Co. v. Central Illinois Public Service Co.*, 314 U.S. 498, 506–08, 62 S.Ct. 384, 397–98, 86 L.Ed. 371 (1942). It is clear that the Natural Gas Act was passed to fill the gap in regulation of the natural gas industry created by judicial holdings precluding state regulation of interstate commerce:

> The Natural Gas Act was designed to supplement state power and to produce a harmonious and comprehensive regulation of the industry. Neither state nor federal regulatory body was to encroach upon the jurisdiction of the other. Congress enacted this Act after full consideration of the problems of production and distribution. It considered the state interests as well as national interests. *Panhandle Eastern Pipe Line Co.*, 337 U.S. at 513, 69 S.Ct. at 1260.
> (Footnotes omitted.)

6. One final question raised concerns the "prudent operator" standard promulgated by Order No. 539–B. The argument is advanced that the "prudent operator" standard is inappropriate to FERC's goal to increase production of natural gas because "prudent operator" is a term of art employed in state regulations which are concerned with increasing the total recovery of hydrocarbons through the *conservation* of natural gas fields rather than permitting operators to waste energy resources by *exploitation* of reserves. We do not reach the issue due to our disposition on jurisdictional grounds.

APPENDIX B [689]

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UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Richard L. Dunham, Chairman; Don S. Smith, John H. Holloman III, and James G. Watt.

Policy With Respect To Enforcement Of Deliverability And Rendition Of Natural Gas Service Under Certificated Arrangements	)	Docket No. RM76-8

ORDER NO. 539-B

ORDER CLARIFYING PRIOR ORDERS AND AMENDING SECTION 157 OF THE COMMISSION'S REGULATIONS UNDER THE NATURAL GAS ACT

(Issued July 30, 1976)

In Order No. 539[1] the Commission reiterated its policy to enforce certificated delivery obligations. In Order No. 539-A[2] the Commission clarified its prior order, granted in part and denied in part reconsideration, and issued a notice of proposed rulemaking to promulgate Section 2.83

1. Promulgating Statement of Policy, Order No. 539, Docket No. RM76-8, ____FPC____ (October 14, 1975).

2. Order Granting In Part And Denying In Part Reconsideration, Clarifying Order No. 539, Denying Stay, Noticing Of Proposed Rulemaking, Noticing Of Oral Argument And Granting Intervention, Order No. 539-A, ____FPC____ (March 26, 1976).

*Bracketed numbers indicate page in agency record.

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as a section of the Commission's General Policy and Interpretations. Written comments on the proposed rulemaking were received and oral argument before the Commission was held on May 4, 1976. The entire record in Docket No. RM76-8 is now before us for final determination.

In Order No. 539, we spoke of a "certificated minimum daily delivery obligation". From the reactions of the parties, we learned that the quoted phrase meant different

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things to different persons, depending, of course, on their respective views of the certainty of natural gas production. Some respondents interpreted the phrase to mean that a producer would be required to deliver a set volume of gas every day for the entire contract term or be subject to the criminal penalties of the Natural Gas Act,[3] while other persons related the meaning of the phrase to the producer's best efforts to deliver presently producible supplies. Our attempt in Order No. 539-A to clarify the meaning of "certificated minimum daily delivery obligation" did not settle the matter, as the continued confusion in the rulemaking proceeding showed. We must conclude that the clause is not one that has a generally accepted meaning among pipelines and producers. In this order, based on all material submitted in Docket No. RM76-8, we will make clear the intention of the Commission with respect to its policy on certificate obligations and enforcement of such obligations.

Under Section 7 of the Natural Gas Act,[4] the Com-

3. Natural Gas Act, §21; 15 U.S.C. §717t.

4. Natural Gas Act, §7; 15 U.S.C. §§717f(a)-(e).

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mission authorizes a natural gas company to perform a service, the sale for resale in interstate commerce of natural gas. In order for this sale by a producer to be lawful, it must procure from the Commission a certificate of public convenience and necessity. This certificate is the physical evidence of the producer's right to commence the approved service.[5] The certificate itself sets forth the terms and conditions under which the producer must operate, which include but are not limited to those obligations incurred by reason of the contract of sale.

Whatever the obligations voluntarily entered into by the producer in the contract of sale with the pipeline, the contract terms must normally bow to the conditions included in the certificate. Where, however, the contract provisions incorporated into the certificate include greater responsibilities

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and obligations than those imposed by the certificates, such as in a warranty of delivery agreement, the producer, of course, will be held accountable to those greater responsibilities and obligations.

Some parties to this proceeding advance the argument that a common term in producer-pipeline contracts called the "sole discretion" clause permits the producer complete control over deliverability to the pipeline. Thus, a typical reservations clause in a sales contract provides, in part, that the seller reserves the right "to operate its property free from any control by Buyer in such manner as Seller, in its *sole discretion* may deem advisable, in-

5. *Atlantic Refining Co. v. Public Service Commission of N.Y.*, 360 U.S. 378, 389 (1959).

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cluding without limitation, the right to drill new wells, to repair and rework wells and to abandon any well . . ."[6] (Emphasis added.) Even though the view that the seller rules the transaction is not universally held even in the industry,[7] the Commission wants to make clear that its certificate conditions, and the incidents of service which is represents, are superior to any limitations on Commission authority contained in the contract.

The question then, which the Commission attempted to address in Order Nos. 539 and 539-A, is what standard or test of deliverability the producer is required to live up to under the provisions of the Natural Gas Act and the rules and regulations of this Commission. Natural gas companies[8], as that term is defined in the Natural Gas Act[9], are required under Sections 4, 5, and 7[10] to fulfill certain service

obligations arising from the Act itself[11], together with other responsibilities that may result from other Federal

6. See, *e.g.*, Comments of Tenneco Oil Company, Docket No. RM76-8, Appendix A, p. 7, filed April 19, 1976.

7. Oral Argument, Tr. 95-96.

8. The Supreme Court's decision in *Phillips Petroleum Company v. Wisconsin*, 347 U.S. 672 (1974) found independent producers to be "natural gas companies" within the meaning of Section 2(6) of the Natural Gas Act, 15 U.S.C. 717a(6).

9. 15 U.S.C. §717a.

10. 15 U.S.C. §§717c, 717d, 717f.

11. *F.P.C. v. Louisiana Power and Light Company*, 406 U.S. 621 (1972); *Pennsylvania Water and Power Company v. F.P.C.*, 343 U.S. 414, 422 (1952).

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or State laws or the law of private contracts. Pursuant to the Act itself, however, jurisdictional sales, service, and operation of natural gas companies must be just, reasonable, not unduly discriminatory, preferential, or otherwise unlawful, and in the public interest.

In response to the allegations that have been made concerning our authority to enforce certificate obligations and to condition certificates to aid in this enforcement, Section 7(e) of the Natural Gas Act[12] provides that, in order for the Commission to issue a certificate of public convenience and necessity, it must determine that the applicant is ". . . able and willing *properly* to . . . perform the service proposed . . ." (emphasis added). Certain parties to this proceeding have asserted that this finding is made only at the commencement of the sale. Such a contention does not comport with the ordinary meaning of "service", which implies a continuing obligation, nor with the remainder of the section, which requires that the applicant be found to be willing to conform to the provisions of the Natural Gas Act and the Commission's Regulations.[13] The Commission has long recognized a distinction between the service to the public that is certificated and the contractual agreement that provides for the sale, especially since the service obligation outlives the contractual authorization.[14] Since the requirement of service continues until the Commission permits abandonment, and since the holder of a certificate from the Commission must comply with the

12. 15 U.S.C. §717f(c).

13. *Mitchell Energy Co. v. F.P.C.*, ____F.2d____, No. 75-3110 (5th Cir., June 11, 1976).

14. *Sunray Mid-Continent Oil Co. v. F.P.C.*, 364 U.S. 137 (1960) at 152-153.

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rules and regulations thereof, it is simply incorrect to assert that the Commission cannot act to preserve the integrity of its certification process by conducting an oversight review of an on-going

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service obligation.[15] A mere reference to the authority granted the Commission in Section 5(a) of the Act[16] should suffice to prove the correctness of the view that the Commission has a continuing responsibility to the public to insure that recipients of certificates issued by the Commission are, throughout the life of the certificate, performing consistent with their obligations under the Natural Gas Act.

Historically, jurisdictional actions of natural gas companies have been reviewed by this Commission on the basis, among others, of whether the company acted prudently under the circumstances presented.[17] The prudent operator standard has long been established as an implied covenant in lease agreements, which means that producers are very familiar with the requirements of this standard.[18] Furthermore, state regulatory agencies, whose

15. *United Gas Pipe Line Co. v. F.P.C.*, 385 U.S. 83, 89 (1966).

16. 5 U.S.C. §717d.

17. *F.P.C. v. Natural Gas Pipeline Company*, 315 U.S. 575 (1942).

18. *See*, Williams, Howard R. and Meyers, Charles J., *Oil and Gas Law*, §806, Prudent-Operator Standard, Volume 5, Matthew Bender & Company, Inc. (1972). *See also*, Oral Argument of May 4, 1976, in Docket No. RM76-8, Tr. 6-7, 62-64, 95-96, 122; *Gas and Oil*, §127 Generally; prudent operator rule, 38 Am. Jur. 2d 601 (1968).

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principal purpose is conservation of natural resources, require producers to conform to their codified regulations, which are consistent with the responsibilities imposed by the prudent operator standard.[19] The Department of the Interior has, in effect, incorporated the prudent operator test into its offshore regulations by the use of the terms "reasonable" and "diligence" in describing the lessee's obligations as set forth in the leasing agreement.[20] Obviously, then, all producers are acquainted with the strictures of the prudent operator standard. Therefore, there should be no contention

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that the Commission's action in the instant order is insufficiently specific for respondents to understand the responsibilities incurred in complying with the prudent operator standard.[21]

Once deliveries have commenced under the certificate, as conditioned, the responsibility for the development and maintenance of the gas reserves underlying the committed acreage rests with the producer, and the applicable standard by which to judge whether a producer is properly proceeding with these responsibilities will be the above-referenced "prudent operator standard".

This standard encompasses the obligations to develop the properties consistent with the performance require-

19. Oral Argument, Tr. 15.

20. 30 C.F.R. §250.33, 43 C.F.R. §§ 3307.3-2, 3307.3-4.

21. Our clarification herein should not be interpreted as relieving pipelines from their obligations, arising under the Natural Gas Act, to enforce certificated contractual obligations unilaterally where the need arises.

ments of lease agreements with mineral owners and/or assignors; all valid rules and regulations of any Federal,[22] state or local government having jurisdiction; and the standard of what a reasonably prudent producer would do with respect to the drilling completion, workover, recompletion or abandonment of wells.

We have set forth in this order the nature and extent of the service obligations incurred by a natural gas company in accepting a certificate from this Commission, along with tracing the historical link between service and prudent operation. Therefore, it is consistent with the expression in Order Nos. 539 and 539-A of a statement of policy, that the Commission reiterates its intention to enforce the prudent operator standard as implicit in the service obligations contained in all existing certificates.

The Commission's authority to hold certificate recipients to the prudent operator standard rests, as we have previously stated, in the concept expressed in the Natural Gas Act as service, as that term has been interpreted by the Commission and the Courts. For example, the Supreme Court in *Sunray Mid-Continent Oil Company v. Federal Power Commission*[23] stated:

22. Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331, *et seq.* *See also,* 30 C.F.R. §§ 250, et seq.; 43 C.F.R. §§ 3300, *et seq.; OCS Orders 1 through 12, Governing Oil, Gas, And Sulphur Leases To The Outer Continental Shelf Gulf Of Mexico Area,* United States Department of the Interior, Geological Survey, Conservation Division, January, 1975.

23. 364 U.S. 137 (1960).

> [t]he Commission's practice supports its authority here in the terms of §7(e). It has long drawn a distinction between the underlying service to the public a natural gas company performs and the specific manifestation—the contractual relationship —which that service takes at a given moment.[24]

The Commission has embodied this idea into its certificates of public convenience and necessity by including as a condition thereof the following language:

> The grant of the certificates issued in paragraph (A) above shall not be construed as a waiver of the requirements of Section 7 of the Natural Gas Act or of Part 154 or Part 157 of the Commission's Regulations thereunder and is without prejudice to any findings or orders which have been or which may hereafter be made by the Commission in any proceedings now pending or here instituted by or against Applicants. Further, our action in this proceeding shall not foreclose or prejudice any future proceedings or objections relating to the operation of any price or related provisions in the gas purchase contracts herein involved. The grant of the certificates aforesaid for service to the particular customers involved does not imply approval of all of the terms of the contracts, particularly as to the cessation of the service upon termination of said contracts as provided by Section 7(b) of the Natural Gas Act. The grant of the certificates aforesaid shall not be

24. *Id.* at 152.

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> construed to preclude the imposition of any sanctions pursuant to the provisions of the Natural Gas Act for the unauthorized commencement of any sales of natural gas subject to said certificates.[25]

The Commission has only recently spoken to the issue presented in this rulemaking procedure, the relationship of the contract to the certificate and which prevails if there is a conflict. In its Opinion No. 662 the Commission held that:

> [t]he contract between Texas Eastern and Gulf obviously gave rise to rights and obligations; much is made in the briefs before us concerning the nature, extent and enforceability of those rights and obligations. We set these matters aside. We look instead to Gulf's certificate of public convenience and necessity, for it too gave rights and obligations, and these are clearly ours to interpret, modify, or enforce as the case may require. (Footnote omitted.)[26]

As an additional objection to a Commission imposed standard of deliverability, the producers have strenuously argued that Section 1(b) of the Natural Gas Act prohibits the Commission from conditioning, pursuant to Section 7(e) of the Act, a certificate to aid in the enforcement of delivery obligations that exist in a contract as certificated. Section 1(b) does not, however, preclude

25. *See, e.g.*, Amoco Production Company, *et al.*, Docket No. CI63-479, *et al.*, issued September 19, 1975.

26. *Gulf Oil Corporation*, Docket No. CI64-26, 51 FPC 1340, 1352 (1974).

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the Commission from enforcing the contractual provisions of a gas sales contract and various delivery obligations contained therein or in the certificate. As the Court indicated in *Phillips Petroleum Company v. Wisconsin*,[27] "sales in interstate commerce for resale by producers to interstate pipeline companies do not come within the 'production or gathering' exemption." Once a contract has been certificated, the obligations must be performed in accordance with the provisions of the Natural Gas Act, including Section 7(b) of the

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Act. If the seller under a certificate is not meeting the delivery obligations of such certificate, there has been either a partial or total abandonment of certificated service which requires Commission approval pursuant to Section 7(b). Accordingly, attachment of a condition to a certificate to assure compliance with Section 7(b) of the Act cannot be considered an unreasonable condition contrary to the requirements of Section 7(e) of the Act. Moreover, Section 1(b) of the Act does not, in any fashion, limit the Commission's authority conferred upon it by Section 7(b).

Despite the Commission's belief that the prudent operator standard is implicit in the service obligation included in all certificates issued by this Commission, we wish to make this point clear to all future certificate applicants by including as a condition in all certificates issued on or after the date of this order notice of the supremacy of the certificate to the contract and the application of the

27. 347 U.S. 672, 680-81 (1954).

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prudent operator standard to deliverability obligations. Therefore, pursuant to the notice of proposed rulemaking set forth in Order No. 539-A, the Commission will amend its Rules and Regulations to add a new Section 157.41, to read as follows:

> On and after July __, 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in interstate commerce shall be conditioned as follows:
>
> All persons making jurisdictional sales pursuant to the authority granted by this certificate are hereby given notice that the contractual obligations between the buyer and the seller are incorporated into the certificate obligations, and that the certificate is further conditioned to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated hereunder.

A party that objects to the inclusion of this condition in its certificate may reject the certificate outright or accept with the reservation of its right to appeal the offending condition under Section 19(b).[28]

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In light of our clarification of Order Nos. 539 and 539-A holding a producer to the legally applicable principle of the prudent operator standard, Section 2.83 of the Commission's Regulations is hereby deleted from the Commission's General Policy and Interpretations. As to

28. 15 U.S.C. §717r.

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all certificates issued from October 14, 1975 to date that contain Section 2.83(d) as a condition thereof, whether accepted and/or whether rehearing or reconsideration of the order issuing said certificate was sought or not, the Section 2.83(d) condition contained therein is hereby vacated, but each and every other condition included in said certificate is fully applicable, unless such condition has become the subject of a petition for rehearing or reconsideration that has been granted by this Commission.

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In lieu of the Section 2.83(d) condition included in all certificates issued on or after the October 14, 1975 date of Order No. 539, the Commission will substitute therefore the prudent operator standard presented herein and incorporated into the Commission's Regulations as new Section 157.41. This provision applies whether rehearing or reconsideration was sought for the Section 2.83(d) condition. If, however, rehearing or reconsideration was sought, whether granted as yet or not, those proceedings are incorporated into this rulemaking proceeding for resolution. Because of the Commission's decision expressed in this order to use the prudent operator test to judge the service obligation of the producer under the certificate, all petitions for rehearing or reconsideration pending before this Commission are granted in part and denied in part.

Finally, the data necessary to facilitate any Commission action deemed necessary in implementing the instant order is either currently required to be filed by the appropriate persons or will be required as a result of our order implementing Form No. 108. More specifically,

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any information and materials submitted by virtue of Form No. 108, Form No. 15 and Form No. 40 will be used to assist the Commission and its Staff in enforcing certificated obligations.

The Commission finds:

(1) The Commission's prior orders, Order Nos. 539 and 539-A, should be clarified consistent with this order.

(2) The notice and opportunity to participate in this proceeding with respect to the matter presently before the Commission through the submission, in writing of comments and through participation at oral argument before the Commission, is consistent and in accordance with all procedural requirements therefore as prescribed in Section 553, Title 5 of the United States Code.

(3) The amendment to Section 157 of the Commission's Regulations Under the Natural Gas Act is necessary and appropriate for the administration of the Natural Gas Act.

(4) Section 2.83 should be deleted from Part 2, Statements of General Policy and Interpretations of the Commission.

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(5) The Commission should include in all certificates issued on or after the date of issuance of this order a condition stating that all sales made pursuant to the certificate are subject to review under the prudent operator standard.

(6) It is the public interest to delete Section 2.83(d)

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as a condition to all certificates issued on or after October 14, 1975, whether such certificates were accepted or not, and insert in its place the condition set forth in the newly promulgated Section 157.41 of the Commission's Regulations under the Natural Gas Act.

(7) It is in the public interest that all petitions for rehearing or reconsideration raising an issue regarding the imposition of Section 2.83(d) as a condition to a certificate are incorporated into this proceeding for disposition of that issue and should be granted in part and denied in part for the reasons expressed in this order.

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The Commission orders:

(A) The Commission's Order Nos. 539 and 539-A are clarified consistent with this order.

(B) The Commission, acting pursuant to its authority under the Natural Gas Act, as amended, particularly Sections 4, 5, 7, and 16 thereof, 15 U.S.C. 717c, 717d, 717f, and 717o, hereby orders that its General Rules, Title 18 of the Code of Federal Regulations, be amended by adding a new Section 157.41 as follows:

> On and after July __, 1976, all certificates of public convenience and necessity for the sale of natural gas for resale in interstate commerce shall be conditioned as follows:
>
> All persons making jurisdictional sales pursuant to the authority granted by this certificate are hereby given notice that the contractual obligations between the buyer and the seller are incorporated into the

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certificate obligations, and that the certificate is further conditioned to require that the seller shall observe the standard of a prudent operator to develop and maintain deliverability from reserves dedicated hereunder.

(C) Section 2.83 is deleted from Part 2, Statements of General Policy and Interpretations of the Commission.

(D) The Section 2.83(d) condition attached to all certificates issued on or after October 14, 1975, is deleted from such certificates and the condition contained in Section 157.41 of the Commission's Regulations under the Natural Gas Act is inserted in its place.

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(E) All petitions for rehearing or reconsideration raising an issue regarding the imposition of Section 2.83(d) or as a condition to a certificate of public convenience and necessity are incorporated into this proceeding for disposition of that issue and are granted in part and denied in part for the reasons expressed in this order.

By the Commission.

Commissioner Watt, dissenting, filed a separate statement appended hereto.

(SEAL)

Kenneth F. Plumb,
Secretary.

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Policy With Respect To Enforcement Of Deliverability And Rendition Of Natural Gas Service Under Certificated Arrangements	)	Docket No. RM76-8

(Issued July 30, 1976)

WATT, Commissioner, *dissenting*:

I have worked hard with my fellow Commissioners in an effort to resolve our differences in this case. Unfortunately, there is one major issue we have not been able to agree upon. Therefore I must dissent.

Order No. 539 from its inception has been a nightmare for the Federal Power Commission. That Order states, "The Commission has concluded that it should formally reiterate its policy with respect to the enforcement of the requirements of the Natural Gas Act . . ." because ". . . Questions concerning deliverability and supply obligations of natural gas producers and natural gas pipelines have arisen in connection with numerous Congressional hearings involving the Natural Gas Act." The Order proceeds then to outline what at the time was thought by a few to be the Federal Power Commission policy.

The Order has brought confusion and misunderstandings because many have interpreted it to be an unauthorized extension of jurisdiction not conferred by the Natural Gas Act. As a result of that October 1975 Order, access to over 18 Bcf of natural gas is being denied to the inter-

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state market. In addition, there could well be a substantial quantity of natural gas that has not been considered for introduction into the interstate market because of fears created by the illegal extensions of authorities assumed by the Federal Power Commission.

Once the Commission paused to look at what had been done in the original Order, Order No. 539-A was issued in an attempt to clarify and straighten out the errors. In my opinion, the rewriting of the policy statement in Order No. 539-A was correctly and properly done. But unfortunately, the majority insisted upon maintaining the §2.83 (d) condition in all certificates. The majority now has recognized that error and in Order 539-B has withdrawn and expunged from all those certificates the ill-conceived language. (I have consistently dissented to the inclusion of the §2.83(d) language in all certificates.)

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Now the majority in an attempt to again clarify and straighten out the problems that continue to multiply, has issued a New Order that in my judgment is, also, in error. It creates a substitute condition (Section 157.41) for all certificates that dictates action which is beyond FPC authority.

In my opinion, the Federal Power Commission authority, conferred by the Natural Gas Act with respect to producers, is limited virtually to rate regulation.[1] The Federal Power Commission does not have the authority

1. See e.g. *Interstate Natural Gas Co. v. F.P.C.;* 331 U.S. 682, 690, 691 (1946) and *Colorado Interstate Gas Co. v. F.P.C.;* 324 U.S. 581, 597-604 (1946).

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to require the development of gas reserves dedicated to the interstate market. That authority rests in the lessor or appropriate governmental agency specifically granted such authority by enabling legislation.

A possible result of today's Order is that additional gas will be lost to the interstate market while producers seek judicial remedy of the errors of the Federal Power Commission. It is unfortunate that the Commission continues to insist upon asserting jurisdiction over activities over which it has no authority.

JAMES G. WATT
Commissioner

APPENDIX C

The Natural Gas Act, 15 U.S.C. § 717 et seq., provides, in pertinent part:

§ 1(b) The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.
15 U.S.C. § 717(b).

§ 7(b) No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.
15 U.S.C. § 717f(b).

§ 7(c) No natural-gas company or person which will be a natural-gas

company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations. ...
15 U.S.C. § 717f(c).

§ 7(e) Except in the cases governed by the provisos contained in subsection (c) of this section, a certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of this chapter and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public

convenience and necessity may require.
15 U.S.C. § 717f(e).